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**The Arbitrage Rebate & Yield Restriction Requirements:
A Practical Guide for IBBA Borrowers**

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► Discussion Outline

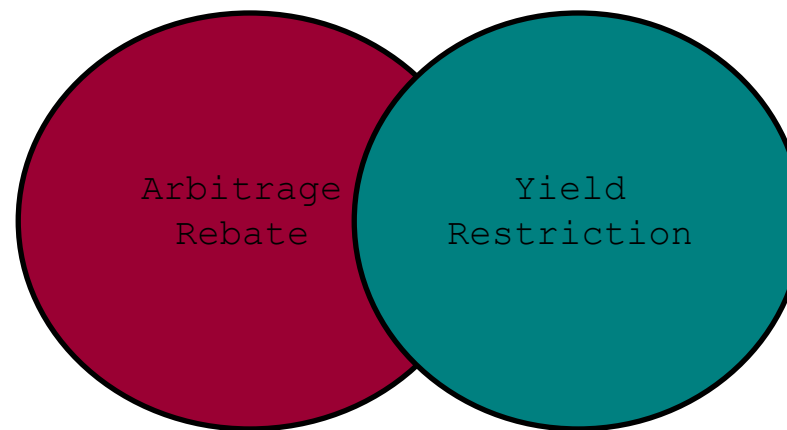
- ✓ Fundamentals of the Arbitrage Rebate and Yield Restriction Requirements
- ✓ Amounts Subject to the Requirements
- ✓ Exceptions to the Arbitrage Rebate Requirements
- ✓ Documents Required to Prepare the Calculations
- ✓ Investment Detail Required to Prepare the Calculations

► Why Should You Care?

- ✓ Arbitrage Bonds = Taxable Bonds
- ✓ Making a payment is not a bad thing
- ✓ Basic understanding of the arbitrage rebate & yield restriction requirements
- ✓ Things you need to track for compliance purposes
- ✓ Recordkeeping and Retention

► Fundamentals - General

- ✓ Two separate requirements though related
- ✓ Need to comply with both requirements to avoid bonds being declared “Arbitrage Bonds”

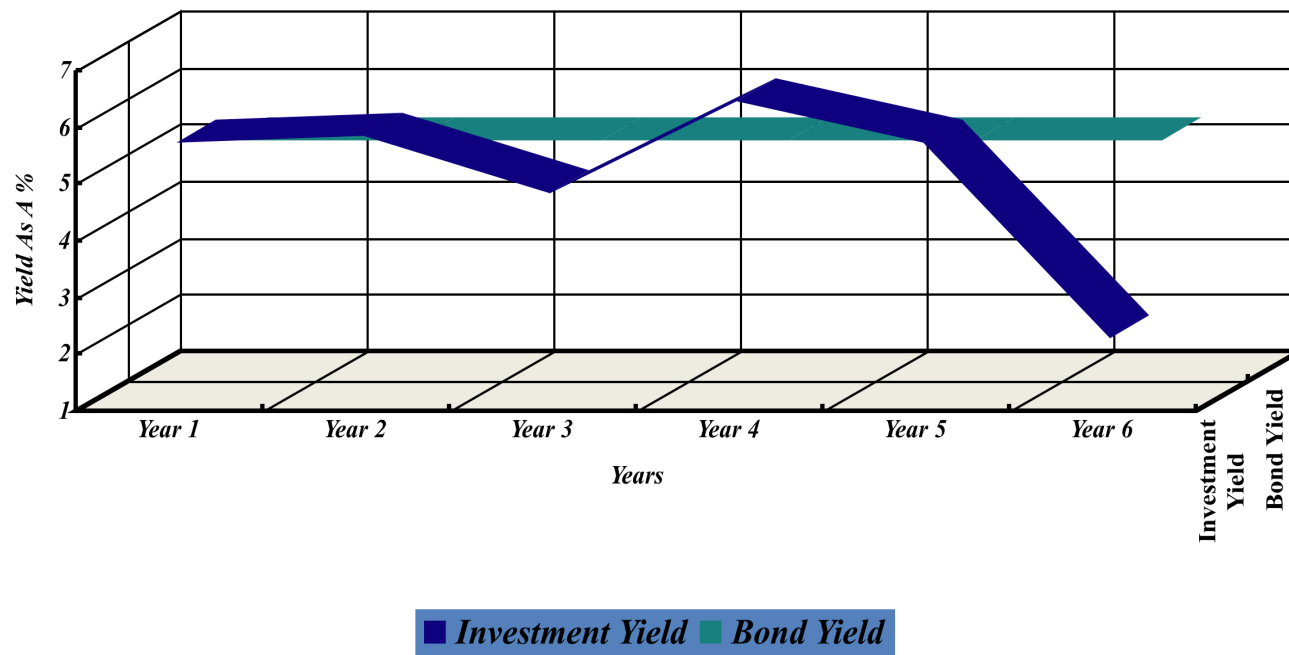


- ✓ Arbitrage rebate – issuers can achieve compliance by remitting a rebate payment to the IRS
- ✓ Yield restriction – issuers can achieve compliance by...
 - Investing yield restricted amounts at a yield below the bond yield or...
 - Remitting a yield reduction payment to the IRS

► Fundamentals – Arbitrage Defined

- ✓ Borrow at tax-exempt rates and invest at higher taxable rates without incurring any additional risk
 - Positive and negative arbitrage
 - When the yield curve is upwards sloping tax-exemption of bond interest allows for positive arbitrage

What Is Arbitrage?



► Fundamentals – Legislative History

- ✓ Tax-exemption is a federal subsidy
- ✓ System was abused
- ✓ Laws and regulations were established to discourage issuers from:
 - Issuing more bonds than needed
 - Issuing bonds sooner than needed
 - Leaving bonds outstanding longer than needed

► Fundamentals – Rebate Defined

- ✓ The *net amount of positive arbitrage* required to be remitted to the Federal government
 - “**Net amount**”- accumulates all arbitrage positions
 - Cumulative Rebate Liability Example
- ✓ Excess earnings on “non-purpose” investments allocated to gross proceeds
- ✓ What would you have earned had invested at the bond yield?
- ✓ What did you earn?
- ✓ Earnings on excess earnings (compounding)
- ✓ An arbitrage rebate payment is net of any yield reduction payments (You are not paying twice)

► Amounts Subject to the Requirements

Arbitrage Rebate

- ✓ Gross proceeds
 - Sale proceeds – amounts received from the sale of the bonds
 - Investment proceeds – earnings on sale proceeds
 - Replacement proceeds – typically amounts pledged to pay debt service
 - Transferred proceeds – prior bond proceeds that become proceeds of the refunding bonds
- ✓ Amounts remaining beyond applicable “temporary period” (3 years)
- ✓ Amounts beyond the “reasonably required reserve,” Minimum of . . .
 - 10% of par amount
 - 125% of average annual debt service
 - Maximum annual debt service
- ✓ Advance refunding escrows
- ✓ Transferred proceeds

► **Amounts Subject to the Requirements**

<u>Arbitrage Rebate</u>	<u>Fund/Account</u>	<u>Yield Restriction</u>
Yes	Construction Fund	Amounts remaining after “temporary period” (3 years)
Yes	Capitalized Interest Account	Amounts remaining after “temporary period” (3 years)
Yes	Reserve Fund	Only amounts above “reasonably required reserve”
Yes	Escrow Fund	Beginning on the issue date

► Exceptions to the Arbitrage Rebate Requirements

- ✓ The Treasury Regulations provide exceptions to the arbitrage rebate requirements allowing all or a portion of gross proceeds to be excluded from the analysis.
- ✓ Small Issuer Exemption
 - \$5 million annual limit (subordinate entities included)
 - IBBA Borrowers – Amount of your IBBA borrowing counts against the overall \$5 million exemption
 - \$15 million (current) exemption for school districts
 - Private activity bonds are not eligible
- ✓ Bona fide debt service fund
 - Funds and/or accounts that provide a “proper matching of revenues and annual debt service”
- ✓ All or a portion of the bond proceeds may be excluded from the arbitrage rebate requirements if they meet a spending exception
- ✓ If you earned positive arbitrage and met an exception you allowed to keep the earnings

▶ Exceptions to the Arbitrage Rebate Requirements

✓ Spending exceptions

▪ Six month spending exception

- Gross proceeds need to be spent within six months
- Gross proceeds do not include amounts deposited in the Reserve Fund

✓ 18 month spending exception

- Spending requirements
 - 15% in 6 months
 - 60% in 12 months
 - 100% in 18 months
- Gross proceeds do not include amounts deposited in the Reserve Fund

▶ Exceptions to the Arbitrage Rebate Requirements

- ✓ 24 month spending exception
 - Applies to “construction” bonds only
 - Only includes “available construction proceeds”
 - Construction Fund
 - Capitalized Interest Account
 - Reserve Fund earnings
 - Spending requirements
 - 10% in 6 months
 - 45% in 12 months
 - 75% in 18 months
 - 100% in 24 months

► Yield Restriction Requirements

- ✓ Separate Requirement
- ✓ Restricts Investment Earnings Relating to Yield Restricted Proceeds
- ✓ Temporary Period – usually 3 years
- ✓ Bond Yield plus 1/8 percent or 12/5 bp
- ✓ Arbitrage rebate and yield reduction payments are required to be paid no later than 60 days after each “5th Bond Year” and 60 days after the final redemption date
- ✓ Idaho Bond Bank Borrowers
 - ✓ Even if a borrower qualifies for a small-issuer exemption, the borrower is never exempt from complying with the yield restriction requirements.



► Documents Required to Prepare the Rebate Calculation

- ✓ Final Official Statement
- ✓ Tax Certificate/Arbitrage Certificate
- ✓ Form 8038-G
- ✓ Trust Indenture
- ✓ Verification Report, if applicable

▶ Investment Detail Required to Prepare the Calculations

- ✓ Bond proceeds need to be tracked from closing until spent
- ✓ Need financial data from closing to the calculation date, if first calculation period
- ✓ If recurrent calculation, need financial data from date of last calculation to the calculation date
- ✓ Are the investment proceeds commingled with other funds? If yes, we need to discuss how to uncommingle those funds.
- ✓ Daily financial activity required
 - Date and amount of expenditures
 - Date and amount of interest postings
 - If expenditure dates do not correspond with maturing investments, need monthly investment yield